

**SOAH DOCKET NO. 582-11-1468
TCEQ DOCKET NO. 2010-1841-UCR**

APPLICATION OF SJWTX, INC, DBA	§	BEFORE THE STATE OFFICE
CANYON LAKE WATER SERVICE	§	
COMPANY TO CHANGE WATER	§	OF
RATES; CCN NO. 10692; IN COMAL	§	
AND BLANCO COUNTIES	§	ADMINISTRATIVE HEARINGS

CEWR'S EXCEPTIONS TO THE PROPOSAL FOR DECISION

TO THE HONORABLE COMMISSIONERS OF THE TEXAS COMMISSION ON ENVIRONMENTAL QUALITY:

The Coalition for Equitable Water Rates ("CEWR"), the ratepayers who will pay the rates set by the Commission, respectfully submits its Exceptions to the Proposal for Decision filed by the Administrative Law Judges on December 3, 2012 and in support of its exceptions would show the following:

I. CEWR'S Exceptions

CEWR's resources to fight this case have been limited from the outset, while CLWSC, on the other hand, has used its superior resources to raise many issues in this case, many of which the ALJs have rightfully rejected. Although CEWR takes issue with a number of the ALJ's findings,¹ CEWR excepts to only one major finding in the PFD and the Proposed Order, for which CEWR requests the Commission's consideration – the ALJs decision to grant a "good cause" exception to the proper exclusion of contributed assets from rate base (invested capital) and the resulting unfair inclusion of \$13.78 million of contributed assets in rate base.

A. CLWSC's Invested Capital/Rate Base - Assets Acquired from the WSC

1. The law does not allow contributed capital to be included in invested capital

The most significant issue in this case, by far, is the rate base valuation of the assets acquired by CLWSC from the predecessor water supply corporation (WSC) in 2006. CEWR has consistently argued that CLWSC's invested capital for these assets should be set at what

¹ CEWR takes issue with a number of the ALJs findings including those regarding assets not used and useful, corporate transfers, return on equity, and bad debt, to name a few. CEWR simply lacks the resources to pursue these issues further.

CLWSC paid for the assets (which seems extraordinarily fair). The ALJs, to the contrary, recommend that these assets be valued the amount shown on the WSC's books. CEWR is agreeable to that approach, provided that CLWSC is not allowed to earn a return on assets that were contributed to the WSC. CEWR believes that CLWSC should be allowed to earn a return on either what it or the WSC invested, but the Commission should not force CLWSC's ratepayers to unnecessarily pay \$13.78 million to the utility twice to achieve accounting perfection, especially when such perfection is not required and many easy solutions exist to fix the accounting problems.

In 1994, several smaller utilities in the Canyon Lake area formed a non-profit WSC to improve the service to the area, in part by financing the construction of a water treatment plant. The value of the assets owned by the WSC at creation was minimal. After its creation, the WSC, and the customers it served, along with the area developers, invested millions of dollars in water plant to serve the area. Some of that plant was paid for by the WSC directly, but a significant amount of the plant (at least \$13.78 million²) was constructed or paid for by the developers and customers and *given to the WSC at no cost*. These contributed assets are referred to in the PFD and herein as contributions in aid of construction or CIAC. These facts are not in dispute. What is in dispute is how to value the assets acquired by CLWSC for purposes of determining CLWSC'S invested capital.

Each of the parties presented its argument about how to value these assets. Table 1 summarizes the differing values offered by the parties.

CLWSC Trended Value	Book Value w/CIAC	ED Acquisition Adj	CEWR Purchase Price	Book Value w/out CIAC
\$29,050,912	25,915,241	21,901,034	16,523,000	12,087,169

The WSC's audited books and records valued the assets at \$25,915,241 (including contributed assets – "CIAC").³ CLWSC argued that the book value of the assets should be adjusted using an engineering-based trending study, which inflated the book cost of the assets (but did not account for or remove CIAC). Under CLWSC's argument, these assets had an

² PFD at 40. The ALJs found that the evidence shows that the WSC received contributions of at least this amount. The amount of CIAC in the record was clearly disclosed in the WSC's audited financial statements.

³ CEWR Closing Arguments, p. 9-10. (\$29,050,912 - \$3,135,671).

original cost of \$29,050,912.⁴ Unquestionably, this amount is far more than what either the WSC or CLWSC paid for the assets.

CEWR argued that the original cost of the assets should be valued at the purchased price paid by CLWSC for the assets. Under CEWR's argument these assets had an original cost of \$16,523,000.⁵ Alternatively, CEWR argued that the original cost of the assets should be determined using book values with the value of CIAC removed from original cost to reflect the amount that the WSC actually paid for the assets. Under CEWR's alternative, these assets had an original cost of \$12,087,169.⁶

The Executive Director argued that the original cost should be set using book values with a negative acquisition adjustment to reflect that CLWSC paid approximately \$4 million less than book value for the assets, reducing CLWSC's invested capital in these assets to \$21,901,034.⁷ The Executive Director's adjustment was based on CLWSC's own accounting disclosure of a negative acquisition adjustment.

The ALJs rejected all of the parties' arguments regarding the original cost of these pre-acquisition assets to include in CLWSC's invested capital. Instead, the ALJs decided to use book value of these assets to reflect the WSC's original cost, but the ALJs recognized that CLWSC should not be allowed to earn a return on CIAC, which the ALJs found to be included in the WSC's book values. The ALJs' view of the record and the law is set out in the PFD:

- "The ALJs have concerns with the inclusion of CIAC in CLWSC's rate-base valuation."⁸
- ***"If CLWSC earns a return on its invested capital that includes the members' CIAC, the WSC members would be paying twice for the property: first when they contributed the property to the WSC; and second, when they pay their water bills based on rates allowing a return on CIAC."***⁹
- "The alleged lack of documentation and differences between IOUs and water supply corporations do not relieve CLWSC of its responsibility to remove CIAC, and any other sources of cost-free capital, from its rate base. Section 231.c)(2)(B)(iv) prohibits customer-CIAC in a utility's original cost or invested capital; it does not allow the

⁴ *Id.*

⁵ CEWR still believes that the law requires that the original cost of these assets be set at the price paid by CLWSC for the assets. The ALJs declined to accept CEWR's position because of the difficulties in determining the purchase price. CEWR disagrees with the ALJs about the difficulty, since CEWR offered uncontroverted expert testimony regarding the purchase price.

⁶ CEWR Closing Arguments, p. 31. (\$25,915,241 book value - \$13,828,072 CIAC)

⁷ Lookerman Direct, p. 20. (\$25,915,214 book value - \$4,014,207 acquisition adjustment).

⁸ PFD at 36.

⁹ PFD at 37 (emphasis added).

inclusion of CIAC if it is too difficult to calculate the amount of CIAC or to determine which assets were acquired with CIAC.”¹⁰

- “The evidence shows that from 1994 to 2005, the WSC received large amounts of CIAC.”¹¹
- “The evidence also shows that CLWSC *did not attempt to determine which property was attributable to CIAC* or to remove CIAC from its rate base.”¹²
- “The ALJs conclude that CLWSC has not shown that its rate base valuation meets the requirements of 30 Tex. Admin Code § 291.31(c)(2)(B)(iv) and § 291.31(c)(3)(A)(iv).”¹³
- *“The ALJs conclude that CLWSC did not meet its burden to show that its proposed rate base calculation complied with 30 Tex. Admin. Cod § 291.31(c)(2) and (c)(3) because it did not exclude CIAC or cost-free capital from its rate base.”*¹⁴

After an exhaustive review and analysis of all of the arguments presented, the ALJs conclude that CLWSC failed to meet its burden of proof regarding how the WSC’s assets should be valued for rate base purposes because CLWSC did not offer a way to exclude CIAC or cost-free capital from its rate base. That should be the end of the story because the utility bears the burden of proof on this issue. Not content to stop there, however, the ALJs then conclude that there is “good cause” to include CIAC and cost-free capital in rate base – good cause being that no records exist to track CIAC to specific assets.¹⁵ **Essentially, the ALJs conclude that CLWSC’s ratepayers must unfairly pay \$13.78 million twice (once when contributing to the WSC and again in rates) because of an accounting difficulty – an accounting difficulty that CLWSC did not even bother trying to address.**

The application of a good-cause exception in this situation is contrary to law and sound policy, and not supported by the evidence in the record. Moreover, it will have lasting adverse effects on CLWSC’s ratepayers as this portion of the rate base will be conclusively established after this case, and because CLWSC (and other IOUs purchasing assets from non-profit utilities) will be able to use this same excuse (lack of records) to inflate its rate base on future purchases

¹⁰ PFD at 39 - 40.

¹¹ PFD at 40.

¹² *Id.* (emphasis added).

¹³ *Id.*

¹⁴ PFD at 54 (emphasis added).

¹⁵ The issue of good cause to not exclude CIAC was not litigated at hearing. It was not raised by CLWSC, the party with the burden of establishing good cause, and CEWR was not put on notice that it needed to rebut a claim of good cause.

of assets from other entities, such as the assets recently purchased by CLWSC from Bexar Metropolitan Water District.

It is unquestionably clear that Texas law does not allow utilities to include CIAC in rate base. Texas Water Code §13.185(b) unequivocally states that CIAC “may not be included in invested capital.” In 1979, the Texas Supreme Court affirmatively held that “contributions in aid of construction should be excluded from a utility’s rate base.”¹⁶ The court expressly recognized that to hold otherwise “would have the effect of requiring the customers to pay twice for the same property” which would be “unjust.”¹⁷ In 1983, the Supreme Court once again held that CIAC must be excluded from rate base.¹⁸ In no reported Texas case has a court recognized a good cause exception to override this rule.¹⁹

The use of a good cause exception in this manner is also legally deficient because it is being applied in an arbitrary manner. An agency acts in an arbitrary manner when it fails to consider a factor the legislature required it to consider; or considers an irrelevant factor.²⁰ An agency also acts in an arbitrary manner if it fails to notify the parties of the grounds on which the agency will rely in reaching a final decision, or if the agency adopts new policies in the course of a contested case without giving the parties pre-hearing notice.²¹ A decision by the Commission allowing CLWSC to include CIAC in rate base would be arbitrary. The statute is clear that CIAC may not be included in rate base. The Commission has articulated no clear standards as to what constitutes good cause to allow CIAC in rate base, and no prior case has held that a lack of records constitutes good cause to ignore clear statutory language. This issue was not even litigated at the hearing because no party asserted that a lack of records constitutes good cause. The ALJs are arbitrarily using the good cause exception to avoid reaching a hard decision.²²

¹⁶ *Sunbelt Util. v. Pubic Util. Comm’n*, 589 S.W.2d 392, 393 (Tex. 1979).

¹⁷ *Sunbelt Util*, 589 S.W.2d at 395 (quoting, *Princess Anne Util. Co. v. Commonwealth*, 179 S.E.2d 714 (Va. 1971)).

¹⁸ *Suburban Util. Corp. v. Public Util. Comm’n*, 652 S.W.2d 358, 365 (Tex. 1983).

¹⁹ The only reported case in which CIAC has been allowed to be included in rate base was a case involving Texas Water Code § 13.185(j), which expressly requires developer contributions made before September 1, 1976, to be treated as invested capital and not CIAC. See *Public Util. Comm’n v. Southwest Water Services, Inc.*, 636 S.W.2d 262, 267 (Tex. App. -- Austin 1982, writ ref’d n.r.e.) (Justice Shannon noted that utilities have actual or constructive notice that CIAC will be excluded from rate base when the Commission considers a rate increase request.)

²⁰ *City of El Paso v. PUC*, 883 S.W.2d 179, 184 (Tex. 1994).

²¹ *AEP Texas Cent. Co. v. PUC*, 286 S.W.3d 450, 475 (Tex. App. – Corpus Christi 2008, pet. denied).

²² Blacks Law Dictionary defines arbitrary as “determined by a judge rather than be fixed rules procedures, or law.”

Providing an exception for the exclusion of CIAC for rate base because of lack of sufficient accounting records to track CIAC to specific assets would also be bad public policy. Whereas the potential financial insolvency of a utility might provide a justification to include CIAC, the stringency of the showing necessary to satisfy good cause should consider the magnitude of the adverse effect on ratepayers as well as on the utility. In other words, the Commission should set a high bar for a good cause adjustment that allows \$13.78 million in assets to be included in rate base as an exception to a statutory requirement.²³

Generally, regulatory agencies have required a showing that an exception was necessary to preserve the financial integrity of a utility before granting “good cause” exceptions in the context of provisions such as Texas Water Code §13.195 and 30 TAC § 291.31(c)(3).²⁴ Such a high bar is appropriate because it reflects the relative burdens placed by the law on utilities and their ratepayers. Utilities have an obligation to play by the rules when maintaining their records regarding costs and to bear the burden of proof to justify rate increases based on those records. If the utility fails to properly maintain its records and meet its burden of proof, it should not be granted a rate increase on the basis of those records, unless it is in the best interests of the ratepayers to provide an exception to keep the utility in business. CLWSC made no showing that its financial integrity can only be preserved through the exceptional remedy of allowing it to include CIAC in rate base. In fact, CLWSC spent more than \$150,000 on a trending study to artificially inflate its rate base, but for a small fraction of that amount CLWSC could have investigated its records to identify CIAC.

The ALJs appear to be promoting perfection at the expense of fairness. While CEWR admits that there may be no perfect way to track CIAC to specific assets, there exist many ways to approximate such tracking. Perfection is not required – an estimate is good enough. Perfection is clearly not required in determining invested capital. As the ALJs themselves recognize, the only way to perfectly determine original costs is with actual invoices, which do

²³ The standard must certainly be something more than a lack of accurate accounting records, otherwise the Commission will be indicating that proper accounting is not important, providing the wrong incentive to utilities, which are otherwise required by law to maintain complete and accurate records. In a rate case, the utility has the burden of proving its rate base because the utility is the only party with access to its books and records. If utilities can avoid removing CIAC from rate base because of a lack of detailed records, the Commission should assume that no IOU will maintain such detailed records in the future.

²⁴ For example, the statute allows for construction work in progress (CWIP) to be included in rate base only if the utility demonstrates, by clear and convincing evidence that the inclusion of CWIP “is in the ratepayers’ best interest and is necessary to the financial integrity of the utility.” TEX. WATER CODE §13.184(b).

not exist with regard to these assets.²⁵ The ALJs are content to estimate original cost, but are for some reason hesitant to estimate the amortization of CIAC, even when the record supports any of a number of ways of performing such estimation. In its closing arguments, CEWR suggested the use of a lump-sum adjustment that would be amortized over the weighted average useful life of the assets. This is similar to the approach offered by the Executive Director to amortize its negative acquisition adjustment. CEWR admits that other approaches exist that would also achieve the same result. Any approach, even an approach that discounted the total amount of CIAC, would be a better approach than including all CIAC in rate base.

What is particularly unfair about the ALJs determination that good cause exists to include all of the CIAC in rate base is the fact that CLWSC knew about the existence of CIAC at the time of acquisition, discounted its purchase offer because of the existence of CIAC, and made no attempt to identify CIAC or to track CIAC to specific assets. CLWSC is the only party with access to the records necessary to identify CIAC and to track CIAC to specific assets. The ALJs claim that there are no records to correlate CIAC to specific assets. This is a mischaracterization of the record. The evidence in the record, rather, shows that that no one bothered to research whether such records existed.

In 2006, CLWSC's expert witness, Dr. Gebhard, performed a detailed study of the WSC's books and records at the time of the acquisition and calculated that the WSC had received \$11,097,000 in CIAC.²⁶ Attachment A is his letter to the WSC's Board of Directors.²⁷ At the time of the acquisition, the Members Equity in the WSC was \$10,976,472.²⁸ Members Equity being the amount of equity the members of the WSC had in the system. For this equity, CLWSC paid the members \$3,200,000. In the letter, Dr. Gebhard tells the Board (his client at the time) that CLWSC's offer of \$3,200,000 is a premium for equity worth \$10,976,472. His conclusion that the offer is a premium is expressly conditioned on CIAC being excluded from the Members Equity. He states, "Based upon the accounting rules of an IOU, SJW is paying a

²⁵ PFD at 23.

²⁶ Ex. CEWR-39

²⁷ CLWSC Ex. 39.

²⁸ CLWSC Ex. 3, p. 6 of 22 (CLWSC001032).

premium for purchasing the water utility assets.”²⁹ **Essentially Dr. Gebhard told the Board that the deal was good only if CLWSC properly excluded CIAC from rate base.**

As shown by Attachment A, and as revealed in cross-examination, CLWSC knew about the possible accounting issues and discounted its offer price to the WSC accordingly. CLWSC was fully apprised of this issue (and the consequences) by Dr. Gebhard before it decided to close on the transaction.³⁰ CLWSC knew that CIAC would present an issue in ratemaking but proceeded with the transaction but only after discounting the offer price to reflect this issue.³¹

A. (CLWSC Witness Jensen) At the time that we entered into this arrangement with Canyon Lake Water Supply Corporation, it was unclear because Canyon Lake Water Supply Corporation came about by a combination or acquisition or donation of, I think, 46 minor, small systems into -- combining into a single entity that became Canyon Lake Water Supply Corporation. As you may know, a lot of small utilities in Texas have no documentation whatsoever related to original cost of facilities. So at the time that we acquired Canyon Lake, we had a picture, but not a clear picture of what the assets were that we acquired at the time.

Q So you discounted the offering price based on that lack of information. Is that correct?

A. Yes, and on -- it was also discounted based on the number of improvements and -- that were needed to the system.

To let CLWSC include CIAC in rate base, given what CLWSC knew at the time it made its offer, would be allow CLWSC to successfully game the system to earn a windfall return.

The evidence in the record also does not support a finding that CIAC cannot be tracked to individual assets. Not looking to see if the assets could be tracked is not the same as determining that they could not be tracked.³² When cross-examined about how he determined such a precise number given CLWSC’s claim about the deficiencies of the records, Dr. Gebhard testified as follows:

Q. So did you look through those records and determine that those dollar amounts were not tracked to assets?

²⁹ CLWSC Ex. 39 (CLWSC000632).

³⁰ Tr. p. 727-728.

³¹ Tr. p. 59.

³² In the STM Application (CLWSC Ex. 3), CLWSC swore that there was not CIAC in the assets of the WSC. Such representation appears inconsistent with observations made by Dr. Gebhard that the WSC had more than \$11 million in CIAC.

A. No, sir, not at that time.³³

CLWSC should not now benefit because of these accounting issues. If any party should have to bear the consequences associated with differences in accounting treatment, it should be the utility and not the ratepayers. The purchase price paid by CLWSC took these differences into account. CLWSC paid less than book value for the assets because of a lack of accounting records and potential issues with CIAC. Now, CLWSC wants to use trended values for these assets to claim an amount greater than book value and ignore CIAC. It would be inexcusable for the Commission to sanction such an approach through the use of a "good cause" exception.

2. Possible Solutions to the Problem

CEWR offered the ALJs two possible solutions to the "lack of records" problem (in addition to its primary solution of using the price paid by CLWSC for the assets). First, CEWR suggested that the CIAC detailed in the evidence in the record could be removed using an adjusted amount amortized over the weighted average useful life of the assets.³⁴ Such an approach would allow CIAC to be removed while recognizing that the value of CIAC assets would decrease over time. The ALJs rejected this approach because they concluded that CEWR's amortization schedules constituted new evidence.³⁵ Anticipating the evidentiary objection, CEWR further suggested that the entire \$13.78 million be removed from rate base without amortization since the party with the burden of proof (CLWSC) failed to establish a proper amortization approach.³⁶ The ALJs rejected this approach, but did not offer a clear explanation for the rejection.³⁷

Contrary to the ALJs' positions on these approaches, CEWR believes that they both remain viable solutions to the problem. In its closing argument, CEWR explained how to adjust the net book value of the pre-acquisition assets to account for CIAC using only the evidence in

³³ Tr. p. 735.

³⁴ CEWR Closing Arguments, p. 30 -31.

³⁵ PFD at 28.

³⁶ CEWR Closing Argument, p. 31.

³⁷ PFD at 28. Recognizing that this solution was a bit draconian, CEWR suggested that the Commission could remove all CIAC in this proceeding but allow CLWSC to establish a proper amortization schedule in a future proceeding. The basis offered in rejecting CEWR's approach was "postponing that decision to a later case would not change the lack of documentation. While responsive to CEWR's concession to help CLWSC, the ALJs' response does not address why it would be inappropriate to remove all CIAC from rate base.

the record.³⁸ CEWR used the book values and useful lives of these assets straight from CLWSC's own books. The only thing new in CEWR's closing arguments was the math needed to calculate the result. Unquestionably, the parties, the ALJs and the Commission are allowed to mathematically manipulate facts during briefing and argument without offending evidentiary constraints – how else will the Commission be able to calculate a final revenue requirement³⁹ or rate? Using the approach suggested by CEWR to adjust for CIAC, CLWSC's total net rate base should be reduced by \$11,600,446⁴⁰ to \$26,495,938⁴¹ and return should be reduced from \$2,461,026 to \$1,711,638.

Alternatively, in its final order, the Commission could simply remove all of the CIAC (\$13,779,242⁴²) from rate base. CLWSC had the burden of proposing and proving up an appropriate amortization schedule for CIAC. CLWSC failed in that burden and should suffer the consequences of that failure. With this adjustment, CLWSC net rate base (invested capital) would become \$24,317,142⁴³ and its return would become \$1,570,887.

CEWR recognizes that other methods exist to solve this problem. Using the purchase price for the assets, or the Executive Director's negative acquisition adjustment, are examples of other approaches. These approaches could be implemented using the existing record. CEWR recognizes that there are problems with the existing record because CLWSC failed to identify the presence of CIAC in its application or direct case. CEWR is seeking a solution that prevents the ratepayers from having to pay for these assets twice. Even an imperfect solution is preferable to a long-term financial penalty to ratepayers.

Another solution that would work within the context of the existing record would be designate the pre-acquisition (non-TWDB) assets as CIAC, which would address the ALJs concerns about tracking to specific assets and would account for some of the known CIAC. The ALJs found that there is insufficient documentation of original cost for these assets (FoF 33, 54 & 60) and that CLWSC failed in its burden of proof to exclude CIAC from these assets. The

³⁸ CEWR Closing Arguments, p. 31.

³⁹ On page 75 of the PFD, the ALJs direct the ED to recalculate Federal Income Tax. This calculation will be indistinguishable from CEWR's calculation of the amortization of the CIAC, and CEWR will not have the opportunity to cross-examine the ED's witness on such a calculation. Yet, the ALJs find not problem with relying on this calculation.

⁴⁰ CEWR Closing Arguments, p. 31.

⁴¹ This is the ALJs rate base (\$38,096,384) less \$11,600,446.

⁴² PFD at 40.

⁴³ ALJ recommended rate base (\$38,096,384) less ALJ determined CIAC (\$13,779,242).

ALJs also found that CLWSC “does not have reliable supporting documentation of original costs” for these assets.⁴⁴ These assets are composed primarily of distribution systems, meters and other assets that are typically donated to a utility by a developer.⁴⁵ Designating these assets as CIAC would effectively remove some (but not all) CIAC, while at the same time allow CIAC to be tracked to specific assets. The net book value of these assets, as of the close of the test year, was \$5,412,223.⁴⁶ Using this approach, CLWSC’s rate base would be reduced to \$32,684,161 and return reduced to \$2,111,397.

One other approach would be for the Commission to find that CLWSC did not meet its burden of proof in justifying its rate application and deny the application completely. The Commission followed this approach in the Double Diamond Utilities case.⁴⁷ The ALJ and the Commission found in that case that Double Diamond failed to properly account for CIAC in calculating its invested capital.⁴⁸ Based on that finding, the ALJ and the Commission found that Double Diamond had failed to meet its burden of proof and denied the application completely. The ALJs’ findings here are indistinguishable from those in Double Diamond – the ALJs have found that CLWSC has failed to meet its burden of proof on its invested capital because it failed to properly account for CIAC. The Commission should deny CLWSC’s application, and roll the rates back to those that existed prior to October 27, 2010 (the effective date of CLWSC’s phase one rates).

If the Commission is unwilling to adopt any of these approaches, but wants to comply with the law, which requires that CIAC be excluded from invested capital, the Commission could remand this matter to SOAH for the limited purpose of determining how much CIAC should be removed from rate base and the appropriate mechanism for removing these contributions. Such a hearing could be very limited. According to the ALJs, the problem with the schedules provided by CEWR in its closing argument was that CLWSC was not provided an opportunity to cross-examine Ms. Heddin on the schedules.⁴⁹ On remand, CLWSC would have the opportunity for cross-examination.

⁴⁴ PFD at 10; FoF 32.

⁴⁵ CEWR Closing Arguments, p. 19; Gebhard Direct, p. 13; Tr. 764-765.

⁴⁶ CEWR Closing Arguments, p. 31; CEWR Ex. 14 (CEWR0000206).

⁴⁷ SOAH Docket 582-08-0698.

⁴⁸ Double Diamond, Proposal for Decision, p. 24-25.

⁴⁹ PFD at 28.

CEWR recognizes that additional hearing will result in additional legal expenses, but such expense is far more acceptable than asking the ratepayers to pay \$13.78 million twice for the same property. Determining the accurate, and fair, valuation of the pre-acquisition assets should be a primary goal of the Commission's regulation of utility rates; a goal that is more important than achieving a quick resolution. The final rate order in this case not only impacts CLWSC's current ratepayers, but it will impact future ratepayers in future rate cases, particularly with regard to rate base, which will be set in stone by the Commission's determination in this case. This case will also impact ratepayers of other IOUs in other rate cases where IOUs acquire assets from WSCs or other non-profits utilities. The Commission should not avoid the issue by arbitrarily hiding behind a "good cause" exception. Also, CEWR does not believe that CLWSC will suffer from additional delay. The rates resulting from the PFD, in its current form, should be close to the interim rates in this matter, which CLWSC is currently charging. A remand would also allow parties to examine the rate structure that will be recommended by the Executive Director as directed by the ALJs on page 91 of the PFD.

II. Numeric Errors in the PFD/Miscellaneous Issues

The PFD contains a few numerical and other errors. The following are the relevant errors identified by CEWR

A. Office Expenses

On page 69 of the PFD, the ALJs reject CLWSC's known and measurable adjustment of \$47,736 to Bad Debt expense, leaving CLWSC with Bad Debt expenses of \$69,003.⁵⁰ However, this adjustment does not flow through to the ALJs' summary on page 75 of the PFD. The Bad Debt expense is a subset of the Office Expense Category.⁵¹ The test year amount for Office Expense (with Bad Debt expenses at \$69,003) shown in the application is \$283,065.⁵² CLWSC proposed no other adjustments to this category.⁵³ CLWSC asserts that the value for Office Expense on page 75 of the PFD (and in FoF 89) should be the test year amount of \$283,065

⁵⁰ CEWR continues to assert that the test year amount of \$69,003 should also be excluded because this does not reflect an actual expense of the utility.

⁵¹ CLWSC Ex. 1, p. 27b of 42.

⁵² *Id.* This is also the amount shown on CLWSC Ex. 51

⁵³ CLWSC adjusted test Office Expense by \$1,070 as part of the normalization adjustment. Using the test year amount removes this adjustment in accordance with the ALJs determination regarding normalization.

rather than \$332,128. With that change, the Total amount of O&M should be reduced from \$5,005,811.55 to \$4,956,748.55.

B. Revenues Generated by Previous Rates

On page 121 of the PFD, the ALJs list two different amounts for Revenues Generated by Previous Rates. CEWR believes that these two amounts should be the same and that amount should be \$6,917,243 as set out in ED Exhibit 9.

C. Effective Date/True-Up

On Page 91 of the PFD, the ALJs conclude that if Final Rates are greater than Phase 1 rates, the effective date of the rate for true-up purposes should be March 15, 2011, and that if the Final Rates are lower than Phase 1 rates, the effective date for true-up purposes should be October 27, 2010. The differing dates appropriately address a deficiency in CLWSC's notice of rate change. Proposed Finding of Fact No. 115 only addresses the situation where Final Rates are greater than Phase 1 rates. CEWR recommends that the Commission modify this Finding of Fact to read:

115. The true-up in this proceeding relates back to the noticed effective date of March 15, 2011, for rates that exceed the Phase 1 rates put in place by CLWSC on October 27, 2010. The true-up relates back to October 27, 2010 for rates that are less than Phase 1 rates.

CEWR further recommends that the Commission include an ordering provision directing CLWSC to make a filing detailing how it will implement the rate true-up within 30 days of the date of the Order.

CONCLUSION AND PRAYER

After considering the foregoing, CEWR respectfully requests that the Commission adopt the ALJ's PFD with the changes suggested herein. Alternatively, CEWR respectfully requests that the Commission remand this matter to the ALJs for the limited purpose of determining the appropriate manner to amortize the CIAC found by the ALJs to have been improperly included in CLWSC's invested capital, and to recommend final rates based on the Commission's determinations relating to the other findings in the PFD.

Respectfully submitted,

MATHEWS & FREELAND, L.L.P.

A handwritten signature in black ink, appearing to read 'Joe Freeland', is written over a horizontal line.

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ATTORNEYS FOR

COALITION FOR EQUITABLE WATER RATES

CERTIFICATE OF SERVICE

I hereby certify that on this 7th day of January 2013, a true and correct copy of the foregoing document was sent to the persons listed below in the manner identified.


Joe Freeland

Docket Clerk
Texas Commission on Environmental Quality
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Attachment A



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October 11, 2005

Board of Directors
Canyon Lake Water Supply Corporation
1399 Sattler Road
Canyon Lake, Texas 78133

RE: Review of Proposed Sale of
Canyon Lake Water Supply Corporation to
SJWTX Water Corporation

Dear Board Members:

GDS Associates, Inc. ("GDS") appreciates the opportunity to present our analysis and report on the proposed sale of the Canyon Lake Water Supply Corporation ("CLWSC") to SJWTX Water Corporation ("SJWTX") a subsidiary of SJW, Inc. ("SJW"). GDS has made an independent review of available information on CLWSC and SJW on issues important to the transaction. Our report is in fulfillment of a letter contract with the Board of Directors as presented on September 1, 2005. We provide neither a formal appraisal, a "due diligence" study, nor a legal opinion. Where appropriate, GDS has relied upon opinions of other professionals who have conducted a more detailed review or analysis, e.g., the Auditors Report or engineering studies.

The work tasks performed to prepare this report were conducted by GDS personnel who collectively have over 100 years of experience in managing water utilities, designing and planning water utility projects, regulating water utilities for the State of Texas, evaluating assets of purchased utilities, serving as financial officer of investor-owned water utilities, performing water utility rate studies, presenting expert witness testimony in courts and administrative law hearings in Texas and other states, and consulting on a large variety of water utility regulatory issues.

In preparing this study, GDS has seen the facilities of CLWSC and San Jose Water Company, interviewed management of both water utilities, examined files of state regulatory agencies in Texas and California, and reviewed relevant documents such as audit reports, engineering studies, water sales summaries, bond indenture agreements, and the proposed contract.

It should be noted that the terms for sale of the assets of CLWSC were set by negotiations between a "willing buyer" and "willing seller" acting free of any coercion, and GDS did not find any evidence to the contrary. Based upon descriptions of both the buyer and seller, SJW pursued the purchase of CLWSC's assets, and the CLWSC Board agreed to consider their offer. A similar request had been rejected earlier. Appraisals are often performed as a substitute for an agreement between a "willing buyer" and a "willing seller." This study is not an appraisal in that sense. Sales of assets are often made where money is not the primary consideration, and it appears that money is not the prime consideration in this proposed transaction between SJW and CLWSC. Accordingly this report is an analysis of the fairness of the sale and is not a substitute for actions of a "willing buyer" and "willing seller."

We understand that some customer/shareholders have expressed a concern that CLWSC was not put up for public bids. GDS will not comment on whether a higher sales price could have been obtained by such an offering. A negotiation process was used to obtain a purchaser that could provide a higher quality service to customers and maintain some local input. As addressed later, other concerns include access to capital and experienced professional management.

OBJECTIVES OF SALE

The primary objective of the sale is change of ownership. As a result of this sale, the water supply corporation ("WSC"), as defined by the State of Texas, will become an investor-owned utility ("IOU"). This new IOU, SJWTX, will also be governed by the laws of the State of Texas and the rules and regulations of the Texas Commission on Environmental Quality ("TCEQ"). The purchaser will be a Texas Corporation that is a subsidiary of SJW Inc., a California Corporation. The new IOU will be directed by a Board of Directors established under Texas law.

If approved by the shareholders of the WSC and the TCEQ and, if no unanticipated glitches are encountered,

- (1) the purchaser will assume all existing debt of the WSC,
- (2) the purchaser will pay a total of \$3,200,000 plus transactional costs for the water utility assets to the WSC,
- (3) SJWTX will form a Board of Directors to assume management of operations, and
- (4) the Board of Directors of the WSC will distribute the remaining assets and dissolve the Corporation.

These four steps result in a change of the water utility from a non-profit corporation to an investor-owned water utility.

The seller and the purchaser each have different reasons for wanting to consummate the sale.

CLWSC - Based upon interviews of management, we believe that CLWSC has three primary reasons for wanting to sell the corporation to SJWTX:

- (1) Quicker access to capital for modification and expansion of the water system,
- (2) Easier access to professionals experienced in the management and operation of water utilities, and
- (3) Maintenance of local input by having existing customers on the Board of Directors.

Although many other investor-owned water utilities could provide the first two items, SJWTX was unique in offering to have members of the current board become members of the new board. The management of CLWSC has good reasons to believe that SJWTX will provide a higher standard of service than other providers.

SJWTX - Based upon interviews of officers and staff of San Jose Water Company, we believe that SJW has three primary reasons for wanting to acquire CLWSC and provide water utility service in Texas:

- (1) The Canyon Lake Region is an opportunity for corporate expansion,
- (2) Management perceives compatibility between the two companies based upon cultural and service similarities, and
- (3) SJW has developed management and engineering programs that can be used to assist CLWSC to increase efficiency, extend equipment life, and provide insights into operations, engineering, and management.

As San Jose Water Company has improved its internal management systems, it has developed a model for sustained growth and development that is appropriate for the problems facing the Canyon Lake region.

COMPARING IOUs TO NON-PROFIT UTILITIES

The significant distinctions between IOUs and non-profit utilities are the organizational management structure and the procedures for establishing rates. WSCs are by definition "member owned and member controlled" with a board of directors elected by vote of the members. Generally, in IOUs the management decisions are made by the directors and officers of the publicly-traded company.

Non-profit utilities are entitled to recover (1) expenses for operations, maintenance, and customer service, (2) all debt costs including principal, interest, and any coverage, and (3) some reasonable expenses for capital expenditures. When non-profit utilities have major capital expenditures, they must acquire additional debt, such as the bonded indebtedness of CLWSC with the Texas Water Development Board ("TWDB").

Investor-owned utilities are entitled, by Texas Law, to recover (1) expenses for operations, maintenance, and customer service, (2) depreciation of its investment, and (3) a reasonable rate of return on its investment. Depreciation enables a utility to recover its investment over a period of time, such as 50 years for a water line, theoretically enabling the utility to have the money to make a future replacement of the water line. IOUs go to the capital markets to borrow money when needed.

Large IOUs, such as SJW, are experienced in going to capital markets to obtain expansion capital. Until an IOU has a rate case by submitting an application to the TCEQ, the water utility cannot increase its rates to recover its investment. Thus, IOUs recover their investment, under Texas Law, only after the investment has become used and useful and after application has been made.

CLWSC cannot borrow money from the TWDB unless its rates provide sufficient monies to make the principal and interest payments to the TWDB plus an additional 25 percent of that total. Thus, CLWSC rates must include the debt service costs of the new plant before the proceeds are used to construct the facilities that provide water service. The switch of CLWSC from a non-profit water corporation to an IOU will eliminate the early recovery of debt service and coverage.

DESCRIPTION OF CLWSC

CLWSC was created in 1992 and began operations in 1994. Its primary objective was to become a regional retail water service provider that delivered cost effective dependable water service to the Canyon Lake region. CLWSC originally served 26 individual subdivisions that had been previously served by several separate entities. It has since expanded to a regional system serving over 60 subdivisions. It currently serves approximately 6,777 connections in a 400 square mile area with 30 employees. CLWSC has an average growth rate of approximately 6 percent annually. By serving such a high growth rate over a large geographic area, the utility must continually expand its infrastructure, requiring additional capital.

CLWSC uses both treated surface water from Canyon Lake and groundwater from an extensive distribution of wells. Surface water is used to provide the base load of service, which currently meets approximately 50 percent of the summer water demand and most of the winter water demand. Groundwater is supplied from several different pump stations as needed to maintain pressure. By having both groundwater and surface water, CLWSC is able to meet water demands during periods where one source or the other may be deficient. By using groundwater in the summer, water levels in the aquifer are maintained and not depleted.

In 2003, CLWSC agreed to accept a TCEQ enforcement order to correct a series of problems. CLWSC has remedied almost all of the cited deficiencies. One outstanding issue concerns meeting the water quality rules regarding disinfection byproducts, and CLWSC has on-going projects in place that should allow it to become compliant in the near future.

CLWSC faces important challenges due to growth and an ever changing regulatory environment. These challenges result in a continuing need for new infrastructure, the money to fund them, and information technology tools to assist in management of the water system.

DESCRIPTION OF SJW

The corporate predecessor to San Jose Water Company was created in 1866. The utility now serves 221,000 connections in a 138 square mile service area with 315 employees. Their service area is nearly fully developed, but growth continues due to infilling and replacement construction with high density developments. Because of the high density development, SJW has developed a series of computer models that quickly and accurately access their capability of providing service. To increase the efficiency of water utility management, SJW has developed many innovative, state-of-the-art computer systems that have reduced paper, made data readily available, and increased employee efficiency. The Company's active promotion of water conservation has resulted in reductions in both the per capita demand for water and the peak demand on the system.

San Jose Water Company has three sources of water: surface water from surrounding areas, groundwater from a dispersed network of wells, and imported water from a state water project. They have a sophisticated system of management where most of the energy for water production is used in off-peak hours to save money and cooperate with electrical companies to reduce peak electrical demand.

San Jose Water Company has had no discernable problems with regulatory authorities in California. No evidence of pending violations or complaints could be found at the California Public Utility Commission.

FISCAL CAPABILITIES

San Jose Water Company has the fiscal capability to absorb and manage the assets of CLWSC. As reported in the Form 10-K for SJW in 2004, the operating revenue was \$166,911,000 with operating income of \$24,117,000 and, at the end of 2004, the total investment in utility plant was \$619,590,000. In contrast, CLWSC operating revenue was \$3,893,906 with comparable net

operating income of \$646,527 and, at the end of 2004, the total investment in utility plant was \$17,589,577. Over the past four years, SJW has added new water utility plant totaling \$156,698,000 for an average annual investment of over \$39,000,000. Over the same four years, the length of pipe has only increased by 15 miles with a growth of 2,300 new customer accounts. Clearly, the investment capability of SJW is sufficient to meet the fiscal needs of CLWSC.

San Jose Water Company's current weighted average cost of capital is 8.8%, a blending of their cost of debt and return on equity. SJWTX will be required to pay property tax, franchise tax, and income tax, all costs avoided by water supply corporations. In practice, taxes may offset the savings in cost of capital, but SJWTX will be able to acquire capital more quickly with fewer problems.

CONTRIBUTED CAPITAL

Since inception, CLWSC has received \$11,097,000 in contributions in aid of construction ("CIAC") from developers and members. Accounting procedures for non-profit organizations require that CIAC be treated as income. Investor-owned utilities record CIAC in a separate account because it is treated as an interest free loan for ratemaking purposes. The result of Canyon Lake's accounting for CIAC as revenue is that the total net assets (retained earnings) of the water supply corporation are \$11,097,000 less than the total net assets shown on the financial statements of CLWSC. SJW is paying a premium to purchase the assets of CLWSC.

FUTURE CUSTOMER INVOLVEMENT

SJW has publicly stated that they intend to maintain the employment of the General Manager, Dale Yates, and the rest of CLWSC's employees. SJW plans to maintain the existing business office and customer service center. From those perspectives, customers should notice no change when they contact the utility.

With the switch of CLWSC from a water supply corporation to an investor-owned utility, there will be several changes required under state law. First, there will be no election of the Board of Directors of SJWTX. SJW has publicly stated the three members of the current Board of CLWSC will be asked to join the new Board. Second, the new Board will not be able to change rates without going through the TCEQ. Currently, TCEQ has appellate jurisdiction over CLWSC's rates, requiring customer appeal before the TCEQ will review the rates as set by the Board of Directors. As an IOU, the company will be bound by the laws, rules, and regulations of Texas law. SJWTX must make application to TCEQ for permission to raise rates, and that

application initiates a process with TCEQ staff that involves public hearings before an administrative law judge in which the customers can participate.

SERVICE EXPECTATIONS

SJW intends to use its engineering models and programs to improve the efficiency of operations and management. Customers should expect improvements in providing dependable, cost effective water utility service. According to SJW, within a five year period from the date of purchase, a computerized operations and management system, similar to the San Jose Water Company system, should be fully operational to solve and manage problems within the Canyon Lake water system. The initial systems will include a computer mapping system connected to a hydraulic model, telemetry upgrades for remote operation, extensive digital records on all items in the water system, and a computerized maintenance management system for the timely dispatch of crews to perform preventive maintenance to extend the service life of existing equipment. With these management systems, proper decisions can be made on operations, maintenance, and capital improvements.

During the interim period from the authorization of the sale until the sale is finalized, SJW will provide a supporting role for engineering and management decisions. Major investments by SJW cannot be expected until ownership is formally transferred.

OTHER SIGNIFICANT ISSUES

Water Conservation – CLWSC purchases Canyon Lake water from the Guadalupe Blanco River Authority ("GBRA"). The CLWSC and GBRA are required to establish and meet water conservation goals. San Jose Water Company actively promotes water conservation and, as noted earlier, has reduced per capita consumption and total system demand. Primarily, water conservation is good stewardship of natural resources.

Debt Risk – The current debt for TWDB bonds is approximately \$20,000,000. For 6,777 connections, the average debt per connection is approximately \$3,000. As a water supply corporation the expectation is that additional bonds will be needed to solve anticipated future problems. By selling the utility assets to an IOU, the fiscal needs of the utility will be met in a different way.

Board of Directors
Canyon Lake Water Supply Corporation
October 11, 2005
Page 8

CONCLUSIONS

A substantial amount of information was collected and analyzed in developing this report on the agreement for CLWSC to sell its water utility assets to SJW. The agreement was negotiated between a "willing seller" and a "willing buyer" with no evidence of any coercion. Based on our review, this is a good match as the resources, tools, and capabilities of SJW will be beneficial to the utility system of CLWSC to insure the future of dependable, cost effective service to CLWSC customers. The agreement between the parties will change the structure of the utility from a non-profit corporation to an investor-owned utility and the water supply corporation will be dissolved.

SJW has the fiscal capability of infusing capital into the CLWSC water utility system to meet the future requirements for infrastructure. It also has the capability of providing management, engineering, operational, and maintenance experience to sustain the growth and development of a water utility. SJW has developed a management philosophy and computer tools to provide for a more efficient operation. Currently, CLWSC obtains its needed capital for infrastructure from bonds issued by the TWDB which requires that rates, sufficient to repay the bonds with additional coverage, be established before the bonds are issued. Under the laws of the State of Texas and the rules and regulations of TCEQ, the IOU will not be able to increase rates for its investments until the new infrastructure is used and useful in providing service and a rate application has been made to TCEQ. This will delay implementation of new rates. In addition, customers are entitled to protest and participate in the TCEQ rate hearings.

In converting from a water supply corporation to an IOU, the customer/shareholders will lose the ability to elect the Board of Directors. However, SJW has stated that it will appoint three of the current directors to the new Board of Directors of the IOU.

As the accounting rules will change from those of a non-profit corporation to those of an IOU, there will be a different accounting treatment for CIAC. Based upon the accounting rules of an IOU, SJW is paying a premium for purchasing the water utility assets of SJW.

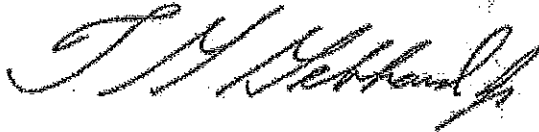
Based upon our review and analysis, I conclude that the sale of CLWSC assets to SJWTX is a fair transaction.

* * * * *

It has been a pleasure to prepare this report for you. If you have any questions, please let me know.

Board of Directors
Canyon Lake Water Supply Corporation
October 11, 2005
Page 9

Very truly yours,

A handwritten signature in dark ink, appearing to read "T. G. Gebhard, Jr.", written in a cursive style.

Thomas G. Gebhard, Jr., P.E., Ph.D.
Managing Director